INSIDE THE TIME-WARNER DEAL • SMART TV • INVESTORS' SURVIVAL KIT

VEMBER 20, 1989

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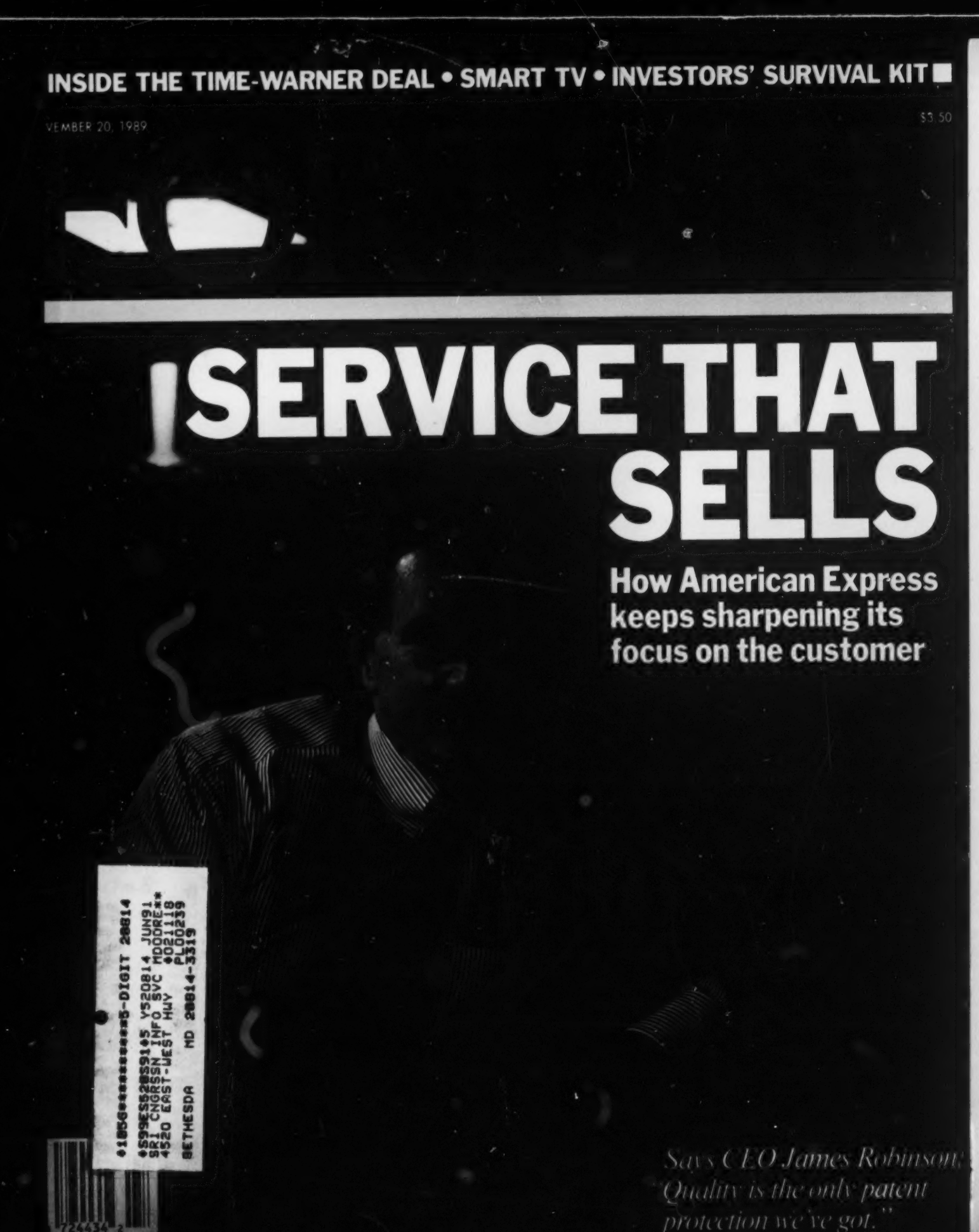
SERVICE THAT SELLS

How American Express keeps sharpening its focus on the customer



Says CEO James Robinson: "Quality is the only patent protection we've got."

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NOVEMBER 20, 1989

FORTUNE

Jim Robinson's horizons are expansive: "Our chief competitor is not Visa or MasterCard. It's cash."

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ABOVE: American Express CEO James D. Robinson III and wife Linda, with friend Ruby, photographed by Rob Kinmonth at their home in Connecticut.

COVER: Gregory Heisler captured Robinson at company headquarters in New York City.

MANAGING/Cover Story

AMERICAN EXPRESS: SERVICE THAT SELLS 80

American Express has waxed mightily by delivering exemplary service to cardholders. In the process the company has compiled revealing records of the spending habits of its customers. Now the company uses that knowledge to market new products. Would you like some mutual funds? Or diamonds perhaps? How about an exercise video called *Buns of Steel*? Here's how Amexco does it. *by John Paul Newport Jr.*

THE PERFECT POWER COUPLE'S PERFECT POWER MARRIAGE 86

Some people will swear that two chief executive officers can't coexist under the same roof for long. But if the two CEOs are deeply in love, like Jim and Linda Robinson, anything is possible.

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The executives at Schwab drew up a disaster plan just months before the quake. It sure came in handy, and next time they will do even better.

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Also: Concept, Sierra On-Line, and Autoclave Engineers.

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COUCH POTATOES! NOW IT'S SMART TV 111

The union of television's images and personal computers' brains is giving birth to dazzling offspring that could revolutionize both industries. Even IBM is tuning in. *by Brenton R. Schlender*

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"We wanted to help America reinvent the consumer electronics business, and they treat us like donkeys."

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"The kids can come out and play now. Before there was shooting at night and there was shooting during the day."

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"The industry criticized us for 19 years. Now Tiffany is trying to do things the Cartier way."

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"You can't teach us anything about the theory of science. And we have the Bolshoi."

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"It was damned controversial. If you ran a board vote on it, it would have failed."

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"Japan is a rigged market. If you don't believe that, you're living on another planet."

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EDITOR'S DESK

ROB KINMONTH

Newport with Jim Robinson at home in Connecticut

WITH ALL THE TALK about America's transformation into a service economy, many a disgusted consumer, sick of standing in lines, is beginning to grumble: "Where's the service?" What's missing, says James D. Robinson III, the energetic chairman of American Express, is a focus on quality—a word he uses all the time, particularly with coworkers. Robinson's company is the subject of the cover story beginning on page 80, "Service That Sells," and he knows whereof he speaks. One top analyst of the credit card business ranks American Express's service "incomparable."

NINA BARNETT

Bill Saporito

In snaring the story on how American Express keeps improving its hold on customers—and how it uses what it knows to sell them more products—associate editor John Paul Newport and reporter Julianne Slovak learned that a long wait can pay off. In September, following six months of on-and-off negotiations, Robinson threw open the door. Newport tagged along with him to staff meetings and luncheons, accompanied him on a trip to Chicago, and spent an afternoon at his Connecticut farm. Says the writer: "That a man in a job like that could find ten hours to be interviewed made me reassess my own time-management skills." To the contrary, Newport's time with Robinson was wisely spent—and yours will be too.

I also commend to you the remarkable article on page 164, "The Inside Story of Time Warner." It is an engrossing account of the year's fiercest takeover tangle, one that, as author Bill Saporito writes, "provoked tremendous controversy and touched every bare-wire business issue of the age: long-term vs. short-term value, shareholder rights, the significance of corporate culture, executive compensation, business ethics, management practice, and merger and acquisition tactics." Because it did all that, we gave it more space than we have any other recent article.

Time Warner is, of course, the parent of FORTUNE's publisher. We treated this story as we do any story: with tough and detailed reporting, fairness, and balance. Writer Saporito, a member of FORTUNE's board of editors, spent months interviewing almost all the principals and studying 12,000 pages of depositions and sworn affidavits. He is a veteran of this sort of thing, having earlier written the 12-page inside story on "How Ross Johnson Blew the Buyout" (April 24). Geoffrey Colvin edited and reporters Rosalind Berlin, Darienne Dennis, and Bill Sheeline assisted. I think you will find their account particularly insightful, useful, and readable.

Marshall Loeb

MANAGING EDITOR

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BY VIVIAN BROWNSTEIN

INCREDIBLE BUT TRUE: THE BUDGET DEFICIT WILL SHRINK

OVERVIEW

- **The deficit as a percent of GNP will be the smallest since 1979.**
- **The economy will grow about 2.5% next year.**
- **Higher inflation in 1990 will complicate budget cutting.**

■ Ah, budget time in the nation's capital. The usual games, tricks, deceits, procrastinations. But not so usual is the rough discipline of the Gramm-Rudman-Hollings sequester—in effect since Congress let the October 16 deadline for hammering out decisions pass—which cuts into government spending at a $16 billion annual rate. As the arguing continues, so do the constraints, which are more severe than anyone in Congress has proposed. The difference may yet get spent—but then again, it may not. The two houses are still far from agreeing on enough reduction in outlays and increase in revenues to comply with the law they imposed on themselves.

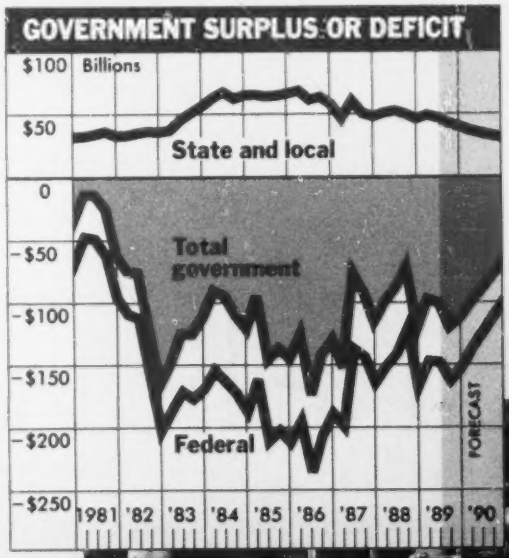
Either way, the big news is that fiscal 1990 is shaping up as a year of genuine progress toward getting the federal deficit under control. If that's hard to believe, blame the maddening chicanery that Washington uses to make the deficit calculations look better than they really are. How—a rational citizen must ask—can any good come of a process so dishonest?

Take the thrift bailout. Of the $50 billion the Administration thinks will be needed to close or merge currently insolvent S&Ls in this and the next fiscal year, $30 billion is "off budget." The funds will be borrowed by the Resolution Funding Corp. (RefCorp), a new government-sponsored "enterprise" concocted for the purpose. Money raised by such enterprises is not technically federal borrowing. But the funds will be turned over to the government and counted as collections, in turn offsetting what the government spends to take care of insolvent S&Ls. And taxpayers will pay a major part of the interest on the borrowing, which will carry a slightly higher rate than ordinary government bonds.

Other gimmicks to meet GRH targets are on a smaller scale, but no less devious. The proposal to move the postal service off budget will save $1.8 billion this fiscal year, and sales of government-owned assets will raise $5.7 billion. In addition, funds appropriated to help California recover from the earthquake's devastation and South Carolina repair Hugo's damage are not likely to be counted as far as the GRH targets are concerned.

And yet. Despite the recurring sordid games and missed targets, the deficit is considerably smaller than at its worst in 1986, and FORTUNE expects more shrinking this year (see chart). On a fiscal year basis, the deficit will drop to an estimated $135 billion from the $152 billion registered for fiscal 1989. At 2.5% of GNP, that would be the smallest deficit since 1979 in relation to the size of the economy. Most important, not all the improvement comes from fancy accounting footwork. Increases in federal spending have slowed markedly. Spending last year was almost $100 billion less than it would have been under pre-1986 policies. And the increase in total 1990 outlays will just about match inflation.

Squeezed hardest is the so-called discretionary half of the budget, which consists mainly of outlays for defense and direct purchases for nondefense purposes. It will be compressed by 2% in real terms. If the automatic spending limits are left in place, the cuts will be larger than we have pro-



CHIEF ECONOMIST *Todd May Jr.*
SENIOR ECONOMIST *Vivian Brownstein*
RESEARCH ASSOCIATES *Lenore Schiff and Lorraine Carson*
FORTUNE's forecast is produced by this magazine's economists using our own economic model.

Construction like this New Jersey recycling plant will nibble at state and local surpluses, adding to the total government deficit.

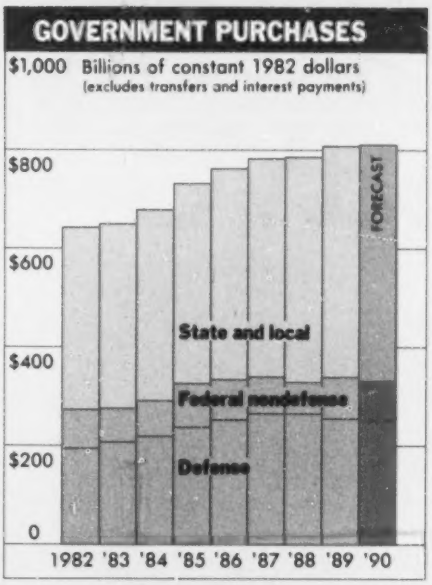
PHOTOGRAPH BY NICK KELSH

jected—a prospect that is increasingly likely the longer the disagreements go on. The $16 billion that must be carved away under sequester is based on calculations by the Office of Management and Budget.

The sequester mechanism assumes that all the deficit reduction will come from lower spending instead of the combination of revenue-raising measures and spending cuts envisioned by the Senate. Instead of a $5 billion trimming, defense will take an $8 billion hit. And unless President Bush gets congressional approval for flexibility in making military cuts, the Army will have to cut its payroll by $1 billion. R&D, including spending for the Strategic Defense Initiative, would lose $200 million that the Administration might rather see spent. Still, OMB director Richard Darman has let it be known that he would just as soon make the automatic spending freeze permanent.

Looking at the fundamentals, sustained economic growth has played a large role in keeping the deficit from ballooning in the past several years. As the unemployment rate sank to its lowest in 15 years, smaller compensation payments helped hold outlays down. But the big bucks came from revenues. Healthy profits and incomes kept tax receipts growing at a fast clip, and larger payrolls fattened Social Security coffers.

One way to see the impact of fast growth is to make a cyclically adjusted calculation comparing actual revenues with those that would have been collected had GNP grown smoothly at its long-run potential of about 2.5% per year. The 3.5% actual average growth of the past four years of recovery generated some $60 billion extra for the feds.



Government won't contribute much to GNP growth next year. Total purchases and payrolls will barely outpace inflation.

That bonus is petering out. Now that the economy has moved back to virtually full employment, it won't keep growing faster than its long-run potential. Real GNP growth has already slowed to a 2.5% annual rate in the second and third quarters, about the average likely for 1990. So budget makers can't count on any more tax dividend. Instead, FORTUNE is assuming the Administration will accede to a modest increase in taxes, on the order of the $5 billion in the Senate budget proposal. Most likely are gasoline and other excise taxes, but the Senate has not made specific suggestions yet. Together with the scheduled January 1 rise in Social Security taxes, that should be enough to increase revenues 8% this year, about as much as in fiscal 1989.

State and local governments are once again moving in a different direction from Washington. The surpluses they built during the years the federal deficit lunged upward are now declining. These surpluses, which totaled $65 billion four years ago, currently amount to some $45 billion and will shrink another $15 billion during 1990.

Like the feds, the states and municipalities need more revenue. Many counties and cities as well as more than half the states have raised taxes during the past year. Outlays will continue to grow faster than receipts, mainly because of the prolonged boom in public works. Projects for new classrooms and community centers as well as sewer facilities, recycling plants, and the like will keep spending up for at least another year. Nevertheless, since these projects are usually financed with borrowing, they won't put many states and localities into budgetary binds. Other outlays can continue to increase along with tax receipts.

Meantime, Washington will muddle through. As the table below shows, the gap between the Gramm-Rudman deficit targets and the deficit will widen again in fiscal 1990. Never mind Darman's estimate that $16 billion will bring the deficit down to the required $100 billion. When it turns out that he undershot the mark, as FORTUNE and many others expect, no one will throw him in jail. It is perfectly legal for the deficit to be over target; you just have to *forecast* that it will come within range.

THE MAIN POINT to keep in mind is that whether by sequester or congressional compromise, America this year will be getting about all the budget cutting it can stand during a period of tepid economic growth. The rise in state and local outlays will offset some of the damping effect of the federal clampdown—which might prove important in keeping the expansion from faltering. But the drop in the cyclically adjusted deficit economists use to measure the budget's economic impact will be as large this year as in 1986, when Gramm-Rudman went into effect. Since the economy was booming then, the drag was hardly noticeable. This time it will be felt.

The budget-cutting game will get much dicier next year. The improvement in the deficit will not ward off a rise in interest rates, since the Federal Reserve will have to tighten as inflation accelerates to the 5.5% that FORTUNE expects for 1990. On our projection, the deficit will have to be cut in half to meet the $64 billion target for fiscal 1991. Any plan for doing that will require much more of a cut than $16 billion, even under the rosiest of scenarios—and much more than the economy could handle. Count on the gap between the proposals and reality to yawn wider than ever. F

GRAMM-RUDMAN-HOLLINGS: MISSING THE TARGETS

FISCAL YEAR	ORIGINAL TARGETS In billions	REVISED TARGETS In billions	ACTUAL DEFICIT In billions	AMOUNT OVERSPENT In billions
1988	–$171		–$221	$50
1987	–$144	–$144	–$150	$6
1988	–$108	–$144	–$155	$11
1989	–$72	–$136	–$152	$16
1990	–$36	–$100	proj. –$135	proj. $35
1991	0	–$64		
1992		–$28		
1993		0		

The gap between Gramm-Rudman and reality will widen again this year, making the next target even more unattainable.